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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

**FORM 10-Q**

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED March 31, 2006
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM \_ TO \_.

Commission file number 0-12820

**AMERICAN NATIONAL BANKSHARES INC.**

(Exact name of registrant as specified in its charter)

VIRGINIA

\_\_\_\_\_  
(State or other jurisdiction of  
incorporation or organization)

54-1284688

\_\_\_\_\_  
(I.R.S. Employer  
Identification No.)

628 Main Street  
Danville, Virginia

\_\_\_\_\_  
(Address of principal executive offices)

24541

\_\_\_\_\_  
(Zip Code)

(434) 792-5111

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes  No

At May 10, 2006, the Corporation had 6,181,882 shares Common Stock outstanding, \$1 par value.

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AMERICAN NATIONAL BANKSHARES INC.

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**American National Bankshares Inc. and Subsidiary**  
**Consolidated Balance Sheets**  
*(Dollars in thousands, except share data)*

	(Unaudited) March 31, 2006	(Audited) December 31, 2005
<b>ASSETS</b>		
Cash and due from banks	\$ 17,986	\$ 18,300
Interest-bearing deposits in other banks	16,261	9,054
Securities available for sale, at fair value	164,610	147,274
Securities held to maturity (fair value of \$17,174 in 2006 and \$18,701 in 2005)	16,883	18,355
Total securities	<u>181,493</u>	<u>165,629</u>
Loans held for sale	873	714
Loans, net of unearned income	411,335	417,087
Less allowance for loan losses	(6,164)	(6,109)
Net loans	<u>405,171</u>	<u>410,978</u>
Bank premises and equipment, at cost, less accumulated depreciation of \$13,405 in 2006 and \$13,194 in 2005	7,734	7,769
Core deposit intangibles, net	92	132
Accrued interest receivable and other assets	9,841	10,927
Total assets	<u>\$ 639,451</u>	<u>\$ 623,503</u>
<b>LIABILITIES and SHAREHOLDERS' EQUITY</b>		
Liabilities:		
Demand deposits -- noninterest bearing	\$ 89,899	\$ 85,965
Demand deposits -- interest bearing	104,479	90,629
Money market deposits	41,557	42,425
Savings deposits	77,258	80,315
Time deposits	191,486	192,317
Total deposits	<u>504,679</u>	<u>491,651</u>
Repurchase agreements	40,672	37,203
FHLB borrowings	17,200	17,238
Accrued interest payable and other liabilities	2,848	3,992
Total liabilities	<u>565,399</u>	<u>550,084</u>
Shareholders' equity:		
Preferred stock, \$5 par, 200,000 shares authorized, none outstanding	-	-
Common stock, \$1 par, 10,000,000 shares authorized, 5,431,438 shares outstanding at March 31, 2006 and 5,441,758 shares outstanding at December 31, 2005	5,431	5,442
Capital in excess of par value	9,610	9,588
Retained earnings	60,088	59,109
Accumulated other comprehensive income (loss), net	(1,077)	(720)
Total shareholders' equity	<u>74,052</u>	<u>73,419</u>
Total liabilities and shareholders' equity	<u>\$ 639,451</u>	<u>\$ 623,503</u>

The accompanying notes are an integral part of the consolidated financial statements.

**American National Bankshares Inc. and Subsidiary**  
**Consolidated Statements of Income**  
*(Dollars in thousands, except per share data) (Unaudited)*

	Three Months Ended	
	March 31	
	2006	2005
<b>Interest Income:</b>		
Interest and fees on loans	\$ 6,956	\$ 6,032
Interest and dividends on securities:		
Taxable	1,152	1,119
Tax-exempt	451	527
Dividends	57	46
Other interest income	232	42
Total interest income	<u>8,848</u>	<u>7,766</u>
<b>Interest Expense:</b>		
Interest on deposits	2,307	1,520
Interest on repurchase agreements	309	153
Interest on other borrowings	213	244
Total interest expense	<u>2,829</u>	<u>1,917</u>
<b>Net Interest Income</b>	<b>6,019</b>	<b>5,849</b>
Provision for Loan Losses	126	300
<b>Net Interest Income After Provision for Loan Losses</b>	<b><u>5,893</u></b>	<b><u>5,549</u></b>
<b>Noninterest Income:</b>		
Trust fees	755	720
Service charges on deposit accounts	571	559
Other fees and commissions	309	251
Mortgage banking income	133	100
Securities gains, net	21	45
Other	112	392
Total noninterest income	<u>1,901</u>	<u>2,067</u>
<b>Noninterest Expense:</b>		
Salaries	1,984	1,872
Pension and other employee benefits	649	468
Occupancy and equipment	646	601
Bank franchise tax	140	138
Core deposit intangible amortization	39	112
Other	925	800
Total noninterest expense	<u>4,383</u>	<u>3,991</u>
Income Before Income Tax Provision	3,411	3,625
Income Tax Provision	1,005	1,042
<b>Net Income</b>	<b><u>\$ 2,406</u></b>	<b><u>\$ 2,583</u></b>
<b>Net Income Per Common Share:</b>		
Basic	\$ 0.44	\$ 0.47
Diluted	\$ 0.44	\$ 0.46
<b>Average Common Shares Outstanding:</b>		
Basic	5,441,758	5,510,614
Diluted	5,477,904	5,558,625

The accompanying notes are an integral part of the consolidated financial statements.



**American National Bankshares Inc. and Subsidiary**  
**Consolidated Statements of Changes in Shareholders' Equity**  
Three Months Ended March 31, 2006 and 2005 (Unaudited)

(Dollars in thousands)

	Common Stock		Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity	
	Shares	Amount			\$		\$
<b>Balance, December 31, 2004</b>	5,521,164	\$ 5,521	\$ 9,474	\$ 55,780	\$ 225	\$ 71,000	
Net income	-	-	-	2,583	-	2,583	
Change in unrealized losses on securities available for sale, net of tax of \$ (519)	-	-	-	-	(1,008)		
Other comprehensive income (loss)					(1,008)	(1,008)	
Total comprehensive income						1,575	
Stock repurchased and retired	(30,400)	(30)	(52)	(671)	-	(753)	
Stock options exercised	918	1	12	-	-	13	
Cash dividends paid	-	-	-	(1,100)	-	(1,100)	
<b>Balance, March 31, 2005</b>	<u>5,491,682</u>	<u>\$ 5,492</u>	<u>\$ 9,434</u>	<u>\$ 56,592</u>	<u>\$ (783)</u>	<u>\$ 70,735</u>	
<b>Balance, December 31, 2005</b>	5,441,758	\$ 5,442	\$ 9,588	\$ 59,109	\$ (720)	\$ 73,419	
Net income	-	-	-	2,406	-	2,406	
Change in unrealized losses on securities available for sale, net of tax of \$ (178)	-	-	-	-	(343)		
Less: Reclassification adjustment for gains on securities available for sale, net of tax of \$ (7)	-	-	-	-	(14)		
Other comprehensive income (loss)					(357)	(357)	
Total comprehensive income						2,049	
Stock repurchased and retired	(13,900)	(14)	(24)	(286)	-	(324)	
Stock options exercised	3,580	3	46	-	-	49	
Cash dividends paid	-	-	-	(1,141)	-	(1,141)	
<b>Balance, March 31, 2006</b>	<u>5,431,438</u>	<u>\$ 5,431</u>	<u>\$ 9,610</u>	<u>\$ 60,088</u>	<u>\$ (1,077)</u>	<u>\$ 74,052</u>	

The accompanying notes are an integral part of the consolidated financial statements.





**American National Bankshares Inc. and Subsidiary**  
**Consolidated Statements of Cash Flows**  
Three Months Ended March 31, 2006 and 2005  
(Dollars in thousands) (Unaudited)

	<u>2006</u>	<u>2005</u>
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 2,406	\$ 2,583
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	126	300
Depreciation	211	231
Core deposit intangible amortization	39	112
Net amortization (accretion) of bond premiums and discounts	31	49
Net gain on sale or call of securities	(21)	(45)
Gain on loans held for sale	(77)	(68)
Proceeds from sales of loans held for sale	2,387	3,003
Originations of loans held for sale	(2,469)	(2,849)
Net (gain) loss on foreclosed real estate	(3)	2
Valuation provision for foreclosed real estate	-	27
Deferred income tax expense (benefit)	113	(68)
Increase in interest receivable	(480)	(291)
Decrease (increase) in other assets	1,606	(70)
Increase in interest payable	68	5
(Decrease) increase in other liabilities	(1,212)	1,263
Net cash provided by operating activities	<u>2,725</u>	<u>4,184</u>
<b>Cash Flows from Investing Activities:</b>		
Proceeds from sales of securities available for sale	165	-
Proceeds from maturities and calls of securities available for sale	14,473	15,094
Proceeds from maturities and calls of securities held to maturity	1,478	2,436
Purchases of securities available for sale	(32,532)	(11,490)
Net decrease (increase) in loans	5,651	(9,162)
Proceeds from sale of bank property and equipment	14	-
Purchases of bank property and equipment	(190)	(236)
Proceeds from sales of foreclosed real estate	66	9
Net cash used in investing activities	<u>(10,875)</u>	<u>(3,349)</u>

(Continued on next page)

**American National Bankshares Inc. and Subsidiary**  
**Consolidated Statements of Cash Flows**  
Three Months Ended March 31, 2006 and 2005  
(Dollars in thousands) (Unaudited)

	<u>2006</u>	<u>2005</u>
<b>Cash Flows from Financing Activities:</b>		
Net increase in demand, money market, and savings deposits	\$ 13,859	\$ 5,539
Net decrease in time deposits	(831)	(1,513)
Net increase in repurchase agreements	3,469	2,024
Net decrease in FHLB borrowings	(38)	(438)
Cash dividends paid	(1,141)	(1,100)
Repurchase of stock	(324)	(753)
Proceeds from exercise of stock options	49	13
Net cash provided by financing activities	<u>15,043</u>	<u>3,772</u>
Net Increase (Decrease) in Cash and Cash Equivalents	6,893	4,607
Cash and Cash Equivalents at Beginning of Period	<u>27,354</u>	<u>12,568</u>
Cash and Cash Equivalents at End of Period	<u>\$ 34,247</u>	<u>\$ 17,175</u>
<b>Supplemental Schedule of Cash and Cash Equivalents:</b>		
<b>Cash:</b>		
Cash and due from banks	\$ 17,986	\$ 16,848
Interest-bearing deposits in other banks	<u>16,261</u>	<u>327</u>
	<u>\$ 34,247</u>	<u>\$ 17,175</u>
<b>Supplemental Disclosure of Cash Flow Information:</b>		
Interest paid	\$ 2,760	\$ 193
Income taxes paid	11	10
Transfer of loans to other real estate owned	30	-
Unrealized loss on securities available for sale	(542)	(1,527)

The accompanying notes are an integral part of the consolidated financial statements.

**AMERICAN NATIONAL BANKSHARES INC. AND SUBSIDIARY  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 - BASIS OF PRESENTATION**

The consolidated financial statements include the amounts and results of operations of American National Bankshares Inc. (the "Corporation") and its wholly owned subsidiary, American National Bank and Trust Company ("the Bank").

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly the Corporation's financial position as of March 31, 2006; the consolidated statements of income for the three months ended March 31, 2006 and 2005; the consolidated statements of changes in shareholders' equity for the three months ended March 31, 2006 and 2005; and the consolidated statements of cash flows for the three months ended March 31, 2006 and 2005. Operating results for the three month periods ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. Certain reclassifications have been made to prior period balances to conform to the current period presentation.

**NOTE 2 - ACQUISITION AND NEW BORROWINGS**

The Corporation acquired Community First Financial Corporation on April 1, 2006. Community First Financial Corporation is the parent company of Community First Bank, which operates four offices serving the City of Lynchburg, Virginia and the counties of Bedford, Campbell and Nelson. The bank had reported assets of \$161 million at December 31, 2005.

In connection with the acquisition, on April 7, 2006, AMNB Statutory Trust I, a Delaware statutory trust (the "Trust") and a newly formed, wholly owned subsidiary of the Corporation, issued \$20,000,000 of preferred securities (the "Trust Preferred Securities") in a private placement pursuant to an applicable exemption from registration. The Trust Preferred Securities mature on June 30, 2036, but may be redeemed at the Corporation's option beginning on June 30, 2011. The Trust Preferred Securities require quarterly distributions by the Trust to the holder of the Trust Preferred Securities at a fixed rate of 6.66%. Effective June 30, 2011, the rate will reset quarterly at the three-month LIBOR rate plus 1.35%. Distributions are cumulative and will accrue from the date of original issuance, but may be deferred by the Corporation from time to time for up to twenty consecutive quarterly periods. The Corporation has guaranteed the payment of all required distributions on the Trust Preferred Securities.

The proceeds of the Trust Preferred Securities received by the Trust, along with proceeds of \$619,000 received by the Trust from the issuance of common securities (the "Trust Common Securities") by the Trust to the Corporation, were used to purchase \$20,619,000 of the Corporation's junior subordinated debt securities (the "Debt Securities"), issued pursuant to a Junior Subordinated Indenture (the "Indenture") entered into between the Corporation and Wilmington Trust Company, as trustee (the "Trustee"). The proceeds of the Debt Securities are being used to fund the cash portion of the merger consideration to the former shareholders of Community First Financial Corporation in connection with the Corporation's acquisition of that company, and for general corporate purposes.

The Debt Securities mature thirty years from issuance, but the Corporation may redeem them, in whole or in part, after five years. The Debt Securities bear interest at a fixed rate of 6.66%. After five years, the rate will become a variable rate that will reset quarterly at the three-month LIBOR rate plus 1.35%.

### NOTE 3 - STOCK BASED COMPENSATION

In the first quarter of 2006, the Corporation adopted Statement of Financial Accounting Standards (“FAS”) No. 123R, “Share Based Payment.” FAS No. 123R requires public companies to recognize compensation expense related to stock based compensation awards in their income statements over the period during which an employee is required to provide service in exchange for such award. There were no stock options granted in the first three months of 2006 and all options were fully vested at December 31, 2005. Therefore, no compensation expense was recorded in the period.

Prior to the implementation of FAS 123R, the Corporation applied APB Opinion No. 25, “Accounting for Stock Issued to Employees” and related interpretations in accounting for stock options. Under APB No. 25, no stock based compensation expense was recorded, as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. FAS No. 123, “Accounting for Stock-Based Compensation,” was issued in October 1995 to establish accounting and reporting standards for stock based employee compensation plans. FAS No. 123 required measurement of compensation expense provided by stock based plans using a fair value based method of accounting, and either recognition of compensation expense in the statement of income or disclosure in the notes to the financial statements. There were no stock options granted in the first three months of 2005 and all options were fully vested at December 31, 2004. Therefore, had the fair value recognition provisions of FAS No. 123 been adopted, there would have been no impact on net income.

There were no tax benefits associated with stock option activity during the first three months of 2006 or 2005. Under FAS 123R, a company may only recognize tax benefits for stock options that ordinarily will result in a tax deduction when the option is exercised (“non-statutory” options). There Corporation has no non-statutory stock options.

**NOTE 4 - SECURITIES**

The amortized cost and estimated fair value of debt and equity securities at March 31, 2006 and December 31, 2005 were as follows (in thousands):

	March 31, 2006			
	Amortized	Unrealized	Unrealized	Estimated
	<u>Cost</u>	<u>Gains</u>	<u>Losses</u>	<u>Fair Value</u>
Securities available for sale:				
Federal agencies	\$ 102,161	\$ -	\$ 1,673	\$ 100,488
Mortgage-backed	21,555	68	498	21,125
State and municipal	31,701	123	464	31,360
Corporate	5,016	25	80	4,961
Equity securities:				
FHLB stock - restricted	2,068	-	-	2,068
Federal Reserve stock - restricted	363	-	-	363
FNMA and FHLMC preferred stock	2,953	257	-	3,210
Other	425	610	-	1,035
Total securities available for sale	<u>166,242</u>	<u>1,083</u>	<u>2,715</u>	<u>164,610</u>
Securities held to maturity:				
Federal agencies	1,500	-	29	1,471
Mortgage-backed	454	9	-	463
State and municipal	14,929	355	44	15,240
Total securities held to maturity	<u>16,883</u>	<u>364</u>	<u>73</u>	<u>17,174</u>
Total securities	<u>\$ 183,125</u>	<u>\$ 1,447</u>	<u>\$ 2,788</u>	<u>\$ 181,784</u>

	December 31, 2005			
	Amortized	Unrealized	Unrealized	Estimated
	<u>Cost</u>	<u>Gains</u>	<u>Losses</u>	<u>Fair Value</u>
Securities available for sale:				
Federal agencies	\$ 80,764	\$ 2	\$ 1,221	\$ 79,545
Mortgage-backed	20,795	104	346	20,553
State and municipal	32,828	159	466	32,521
Corporate	8,025	52	71	8,006
Equity securities:				
FHLB stock - restricted	2,060	-	-	2,060
Federal Reserve stock - restricted	363	-	-	363
FNMA and FHLMC preferred stock	3,104	120	-	3,224
Other	425	577	-	1,002
Total securities available for sale	<u>148,364</u>	<u>1,014</u>	<u>2,104</u>	<u>147,274</u>
Securities held to maturity:				
Federal agencies	1,499	-	28	1,471
Mortgage-backed	482	12	-	494
State and municipal	16,374	407	45	16,736
Total securities held to maturity	<u>18,355</u>	<u>419</u>	<u>73</u>	<u>18,701</u>
Total securities	<u>\$ 166,719</u>	<u>\$ 1,433</u>	<u>\$ 2,177</u>	<u>\$ 165,975</u>



The table below shows (in thousands) gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at March 31, 2006.

	Total		Less than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Federal agencies	\$ 100,017	\$ 1,702	\$ 45,878	\$ 590	\$ 54,139	\$ 1,112
Mortgage-backed	13,604	498	2,444	78	11,160	420
State and municipal	25,295	508	11,283	119	14,012	389
Corporate	1,405	80	-	-	1,405	80
<b>Total</b>	<b>\$ 140,321</b>	<b>\$ 2,788</b>	<b>\$ 59,605</b>	<b>\$ 787</b>	<b>\$ 80,716</b>	<b>\$ 2,001</b>

Management evaluates securities for other-than-temporary impairment quarterly, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. At March 31, 2006, the Bank held eighty-seven debt securities having continuous unrealized loss positions for more than twelve months. Ratings for these debt securities were as follows: Forty of the federal agency bonds and mortgage-backed securities were rated AAA and one was rated Aa2; forty-one of the state and municipal bonds were rated AAA, two were rated AA, and one was rated A; and two corporate bonds were rated A. The unrealized losses are attributable to interest rate changes and not credit concerns of the issuer. The Corporation has the intent and ability to hold these securities for the time necessary to recover the amortized cost.

The table below shows (in thousands) gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2005.

	Total		Less than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Federal agencies	\$ 73,130	\$ 1,249	\$ 18,667	\$ 190	\$ 54,463	\$ 1,059
Mortgage-backed	15,048	346	8,717	203	6,331	143
State and municipal	25,020	511	16,680	233	8,340	278
Corporate	1,414	71	-	-	1,414	71
<b>Total</b>	<b>\$ 114,612</b>	<b>\$ 2,177</b>	<b>\$ 44,064</b>	<b>\$ 626</b>	<b>\$ 70,548</b>	<b>\$ 1,551</b>



## NOTE 5 - LOANS

Loans, excluding loans held for sale, were comprised of the following:

	<u>March 31, 2006</u>	<u>December 31, 2005</u>
(in thousands)		
Real estate:		
Construction and land development	\$ 51,702	\$ 50,092
Commercial	138,103	142,968
1-4 family residential	98,719	94,405
Home equity	39,533	42,178
Total real estate	<u>328,057</u>	<u>329,643</u>

The following is a summary of information pertaining to impaired loans:

	<u>March 31, 2006</u>	<u>December 31, 2005</u>
(in thousands)		
Impaired loans without a valuation allowance	\$ -	\$ -
Impaired loans with a valuation allowance	3,528	3,532
Total impaired loans	<u>\$ 3,528</u>	<u>\$ 3,532</u>
Allowance provided for impaired loans, included in the allowance for loan losses	<u>\$ 652</u>	<u>\$ 639</u>

The following table summarizes average balances and interest income related to impaired loans:

	<u>Three Months Ended March 31, 2006</u>	<u>Three Months Ended March 31, 2005</u>
Average balance in impaired loans	<u>\$ 3,554</u>	<u>\$ 6,099</u>
Interest income recognized on impaired loans	<u>\$ 8</u>	<u>\$ 11</u>

No additional funds are committed to be advanced in connection with impaired loans.

Nonaccrual loans excluded from impaired loan disclosure amounted to \$1,090,000 and \$1,222,000 at March 31, 2006 and December 31, 2005, respectively. If interest on nonaccrual loans had been accrued, such income would have approximated \$66,000 and \$9,000 for the three-month periods ended March 31, 2006 and 2005, respectively. Interest income recorded on nonaccrual loans was \$24,000 and \$21,000 for the three-month periods ended March 31, 2006 and 2005, respectively.

Loans past due 90 days and still accruing interest amounted to \$0 at March 31, 2006 and \$56,000 at December 31, 2005.

Foreclosed real estate was \$155,000 at March 31, 2006 and \$188,000 at December 31, 2005, and is reflected in other assets on the Consolidated Balance Sheets.

## NOTE 6 - ALLOWANCE FOR LOAN LOSSES

Activity in the allowance for loan losses for the three months ended March 31, 2006 and 2005, and for the year ended December 31, 2005 was as follows:

(in thousands)	March 31	December 31	March 31
	2006	2005	2005
Balance, January 1	\$ 6,109	\$ 7,982	\$ 7,982
Provision for loan losses	126	465	300
Loans charged-off	(151)	(2,577)	(233)
Recoveries of loans charged-off	80	239	78
Balance at end of period	<u>\$ 6,164</u>	<u>\$ 6,109</u>	<u>\$ 8,127</u>

## NOTE 7 - EARNINGS PER SHARE

The following shows the weighted average number of shares used in computing earnings per share and the effect on weighted average number of shares of potential dilutive common stock. Potential dilutive common stock had no effect on income available to common shareholders.

	Three Months Ended			
	March 31			
	2006		2005	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	5,441,758	\$ .44	5,510,614	\$ .47
Effect of dilutive securities (stock options)	36,146	-	48,011	(.01)
Diluted earnings per share	<u>5,477,904</u>	<u>\$ .44</u>	<u>5,558,625</u>	<u>\$ .46</u>

Certain options on common stock were not included in computing diluted earnings per share for the three month periods ended March 31, 2006 and 2005, because their effects were antidilutive. These shares totaled 88,227 and 99,350 for the three month periods ended March 31, 2006 and 2005, respectively.

## NOTE 8 - DEFINED BENEFIT PLAN

Components of Net Periodic Benefit Cost  
(in thousands)

	Three Months Ended March 31	
	2006	2005
Service cost	\$ 26	\$ 110
Interest cost	88	92
Expected return on plan assets	(110)	(126)
Amortization of prior service cost	(6)	(9)
Amortization of net obligation at transition	-	-
Recognized net actuarial loss	53	21
Net periodic benefit cost	<u>\$ 151</u>	<u>\$ 88</u>

During the three month period ended March 31, 2006, \$0 in contributions were made. The Corporation plans to contribute \$1,500,000 for the year ending December 31, 2006.

## NOTE 9 - SEGMENT AND RELATED INFORMATION

In accordance with FAS No. 131, "Disclosures About Segments of an Enterprise and Related Information," reportable segments include community banking and trust and investment services.

Community banking involves making loans to and generating deposits from individuals and businesses. All assets and liabilities of the Bank are allocated to community banking. Investment income from securities is also allocated to the community banking segment. Loan fee income, service charges from deposit accounts and non-deposit fees such as automatic teller machine fees and insurance commissions generate additional income for community banking.

Trust and investment services include estate planning, trust account administration, and investment management. Investment management services include purchasing equity, fixed income and mutual fund investments for customer accounts. The trust and investment services division receives fees for investment and administrative services. Fees are also received by this division for individual retirement accounts managed for the community banking segment.

Segment information for the three month periods ended March 31, 2006 and 2005 is shown in the following table. The "Other" column includes corporate items, results of insignificant operations and, as it relates to segment profit (loss), income and expense not allocated to reportable segments. Inter-segment eliminations primarily consist of the Corporation's investment in the Bank and related equity earnings.

	<b>Three Months Ended March 31, 2006</b>					
	<b>Community Banking</b>	<b>Trust and Investment Services</b>		<b>Intersegment Other Eliminations</b>		<b>Total</b>
Interest income	\$ 8,848	\$ -	\$ -	\$ -	\$ -	\$ 8,848
Interest expense	2,829	-	-	-	-	2,829
Non-interest income - external customers	1,025	879	(3)	-	-	1,901
Operating income before income taxes	3,065	400	(54)	-	-	3,411
Depreciation and amortization	245	5	1	-	-	251
Total assets	638,266	-	1,185	-	-	639,451
Capital expenditures	190	-	-	-	-	190

	<b>Three Months Ended March 31, 2005</b>					
	<b>Community Banking</b>	<b>Trust and Investment Services</b>		<b>Intersegment Other Eliminations</b>		<b>Total</b>
Interest income	\$ 7,766	\$ -	\$ -	\$ -	\$ -	\$ 7,766
Interest expense	1,917	-	0	0	0	1,917
Non-interest income - external customers	1,278	788	1	-	-	2,067
Non-interest income - internal customers	-	12	-	(12)	-	-
Operating income before income taxes	3,281	390	(46)	-	-	3,625
Depreciation and amortization	338	4	1	-	-	343
Total assets	625,080	-	600	-	-	625,680
Capital expenditures	203	33	-	-	-	236

## **ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The purpose of this discussion is to focus on important factors affecting the financial condition and results of operations of American National Bankshares Inc. and American National Bank and Trust Company. The discussion and analysis should be read in conjunction with the Consolidated Financial Statements and supplemental financial data.

This report contains forward-looking statements with respect to the financial condition, results of operations and business of the Corporation. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Corporation and on information available to management at the time these statements and disclosures were prepared. Factors that may cause actual results to differ materially from those expected include the following:

- . General economic conditions may deteriorate and negatively impact the ability of borrowers to repay loans and depositors to maintain account balances.
- . Plant closings or layoffs in the Corporation's primary market area could occur, which might negatively impact the ability of borrowers to repay loans and depositors to maintain account balances.
- . Changes in interest rates could increase or reduce income.
- . Competition among financial institutions may increase.
- . Businesses that the Corporation is engaged in may be adversely affected by legislative or regulatory changes, including changes in accounting standards.
- . New products developed or new methods of delivering products could result in a reduction in business and income for the Corporation.
- . Adverse changes may occur in the securities market.

### **Reclassification**

In certain circumstances, reclassifications have been made to prior period information to conform to the 2005 presentation.

### **Critical Accounting Policies**

The Corporation's critical accounting policies are listed below. A summary of the Corporation's significant accounting policies is set forth in Note 1 to the Consolidated Financial Statements in the Corporation's 2005 Annual report on Form 10-K.

The Corporation's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The financial information contained within the statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained when earning income, recognizing an expense, recovering an asset or relieving a liability. In addition, GAAP itself may change from one previously acceptable method to another method. Although the economics of the transactions would be the same, the timing of events that would impact those transactions could change.

## Allowance for Loan Losses

The allowance for loan losses is an estimate of the losses inherent in the loan portfolio at the balance sheet date. The allowance is based on two basic principles of accounting: (i) Statement of Financial Accounting Standards (“FAS”) No. 5, *Accounting for Contingencies*, which requires that losses be accrued when they are probable of occurring and estimable and (ii) FAS No. 114, *Accounting by Creditors for Impairment of a Loan*, which requires that losses on impaired loans be accrued based on the differences between the value of collateral, present value of future cash flows, or values observable in the secondary market, and the loan balance.

The Corporation’s allowance for loan losses has three basic components: the formula allowance, the specific allowance and the unallocated allowance. Each of these components is determined based upon estimates that can and do change. The formula allowance uses a historical loss view as an indicator of future losses along with various qualitative factors, including levels and trends in delinquencies, nonaccrual loans, charge-offs, and recoveries; trends in volume and terms of loans; effects of changes in underwriting standards; experience of lending staff; economic conditions; and portfolio concentrations. In the formula allowance, the historical loss rate is combined with the qualitative factors, resulting in an adjusted loss factor for each risk-grade category of loans. The adjusted loss factor is multiplied by the period-end balances for each risk-grade category. The formula allowance includes an allowance for unfunded commitments, which is calculated by multiplying an estimated loss factor by an estimated probability of funding, and then by the period-end amounts for unfunded commitments. The specific allowance uses the value of collateral, present value of future cash flows, or values observable in the secondary market to arrive at an estimate of loss for specifically identified impaired loans. The unallocated allowance includes estimated losses whose impact on the portfolio has yet to be recognized in either the formula or specific allowance. The use of these values is inherently subjective and actual losses could be greater or less than the estimates.

### **Non-GAAP Presentations**

The Management’s Discussion and Analysis may refer to the efficiency ratio, which is computed by dividing noninterest expense by the sum of net interest income on a tax equivalent basis and noninterest income (excluding gains on sales of securities or other assets). This is a non-GAAP financial measure which management believes provides investors with important information regarding the Corporation’s operational efficiency. Comparison of the Corporation’s efficiency ratio with those of other companies may not be valid because other companies may calculate the efficiency ratio differently.

The analysis of net interest income in this document is performed on a tax equivalent basis. Management believes the tax equivalent presentation better reflects total return, as many financial assets have specific tax advantages that modify their effective yields. A reconciliation of tax-equivalent net interest income to net interest income is provided.

## **New Accounting Pronouncements**

In March 2006, FASB issued FAS No. 156, "Accounting for Servicing of Financial Assets--an amendment of FASB Statement No. 140." This Statement amends FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," with respect to the accounting for separately recognized servicing assets and servicing liabilities. This Statement: 1. Requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations: (a) A transfer of the servicer's financial assets that meets the requirements for sale accounting, (b) A transfer of the servicer's financial assets to a qualifying special-purpose entity in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities in accordance with FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities," and (c) An acquisition or assumption of an obligation to service a financial asset that does not relate to financial assets of the servicer or its consolidated affiliates, 2. Requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable, and 3. Permits an entity to choose either of the following subsequent measurement methods for each class of separately recognized servicing assets and servicing liabilities: (a) Amortization method—Amortize servicing assets or servicing liabilities in proportion to and over the period of estimated net servicing income or net servicing loss and assess servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date, (b) Fair value measurement method—Measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value in earnings in the period in which the changes occur, (c) At its initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under Statement 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value, or (d) Requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities.

The Corporation does not anticipate this Statement will have a material effect on its financial statements.

Refer to the Corporation's December 31, 2005 Annual Report on Form 10-K for previously announced accounting pronouncements.

## **Internet Access to Corporate Documents**

The Corporation provides access to the SEC filings through its web site at [www.amnb.com](http://www.amnb.com). After accessing the web site, the filings are available upon selecting the Investor Relations icon. Reports available include the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are electronically filed with the SEC. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at [www.sec.gov](http://www.sec.gov).

## EXECUTIVE OVERVIEW

American National Bankshares Inc. is the holding company of American National Bank and Trust Company, a community bank with fifteen full service offices and one loan production office. Full service offices are located in Danville, Chatham, Collinsville, Gretna, Martinsville, Henry County, South Boston and Bedford County, Virginia and in Yanceyville, North Carolina. The Bank also operates a loan production office in Greensboro, North Carolina. American National Bank and Trust Company provides a full array of financial products and services, including commercial, mortgage and consumer banking; trust and investment services; and insurance. Services are also provided through nineteen ATMs, “AmeriLink” Internet banking, and 24-hour “Access American” phone banking. Additional information is available on the Bank’s website at [www.amnb.com](http://www.amnb.com). The shares of American National Bankshares Inc. are traded on the NASDAQ National Market under the symbol “AMNB.”

The Bank specializes in providing financial services to businesses and consumers. Current priorities are to:

- increase the size of the loan portfolio without sacrificing credit quality or pricing,
- grow checking, savings and money market deposits,
- increase fee income through the Bank’s trust, investment, and mortgage banking services and
- continue to control costs.

On April 1, 2006, the Corporation acquired Community First Financial Corporation, the parent company of Community First Bank (“CFB”), which operates four offices serving the city of Lynchburg, Virginia and the counties of Bedford, Campbell and Nelson. CFB had reported assets of \$163 million at December 31, 2005. The financial impact of the acquisition will be reflected in the Corporation’s financial statements beginning April 1, 2006.

## ANALYSIS OF OPERATING RESULTS

### Net Interest Income

Net interest income, the Corporation’s largest source of revenue, is the excess of interest income over interest expense. Net interest income is influenced by a number of factors, including the volume and mix of interest-earning assets and interest-bearing liabilities, interest rates earned on earning assets, and interest rates paid on deposits and borrowed funds. For analytical purposes, net interest income is adjusted to a taxable equivalent basis to recognize the income tax savings on tax-exempt assets, such as state and municipal securities. A tax rate of 34% was used in adjusting interest on tax-exempt assets to a fully taxable equivalent (“FTE”) basis. Net interest income divided by average earning assets is referred to as the net interest *margin*. The difference between the average rate earned on earning assets and the average rate paid on interest-bearing liabilities is referred to as the net interest *spread*.

In comparison to the first quarter of 2005, net interest income on a tax-equivalent basis increased \$123,000, or 2.01%. The interest rate spread fell from 3.74% to 3.60% and the interest margin increased to 4.14% from 4.10%.

Net interest income improved primarily due to interest rate increases. The Federal Reserve raised short-term interest rates by .50% during the first quarter of 2006.

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the first quarter of 2005 and 2006. Nonaccrual loans are included in average balances. Interest income on nonaccrual loans, if recognized, is recorded on a cash basis or when the loan returns to accrual status.

### Net Interest Income Analysis

For the Three Months Ended March 31, 2006 and 2005

(in thousands, except rates)

	Average Balance		Interest Income/Expense		Yield/Rate	
	2006	2005	2006	2005	2006	2005
<b>Loans:</b>						
Commercial	\$ 70,421	\$ 72,734	\$ 1,238	\$ 1,133	7.03%	6.23%
Real Estate	331,522	323,473	5,508	4,603	6.65	5.69
Consumer	10,221	14,172	229	320	8.96	9.03
Total loans	412,164	410,379	6,975	6,056	6.77	5.90
<b>Securities:</b>						
Federal agencies	90,141	82,256	807	648	3.58	3.15
Mortgage-backed	21,626	28,530	245	307	4.53	4.30
State and municipal	47,419	53,306	673	802	5.68	6.02
Other	12,372	16,760	146	196	4.72	4.68
Total securities	171,558	180,852	1,871	1,953	4.36	4.32
Deposits in other banks	21,304	6,852	240	42	4.51	2.45
Total interest-earning assets	605,026	598,083	9,086	8,051	6.01	5.38
Non-earning assets	26,908	23,058				
Total assets	\$ 631,934	\$ 621,141				
<b>Deposits:</b>						
Demand	\$ 97,050	\$ 79,426	303	104	1.25	0.52
Money market	41,414	52,130	221	155	2.13	1.19
Savings	78,256	83,361	187	130	0.96	0.62
Time	196,013	193,261	1,596	1,131	3.26	2.34
Total deposits	412,733	408,178	2,307	1,520	2.24	1.49
Repurchase agreements	39,941	39,326	309	153	3.09	1.56
Other borrowings	17,230	21,294	213	244	4.94	4.58
Total interest-bearing liabilities	469,904	468,798	2,829	1,917	2.41	1.64
<b>Noninterest bearing demand deposits</b>						
	85,025	78,440				
Other liabilities	3,105	2,725				
Shareholders' equity	73,900	71,178				
Total liabilities and shareholder's equity	\$ 631,934	\$ 621,141				
Interest rate spread					3.60%	3.74%
Net interest margin					4.14%	4.10%
Net interest income (taxable equivalent basis)			6,257	6,134		



Less: Taxable equivalent adjustment	<u>238</u>	<u>285</u>
Net interest income	<u>\$ 6,019</u>	<u>\$ 5,849</u>

### Changes in Net Interest Income (Rate/Volume Analysis)

	Three months ended March 31, 2006 vs. 2005			Annualized Three months ended March 31, 2006 vs. 2005		
	Interest Increase	Change Attributable to		Interest Increase	Change Attributable to	
	(Decrease)	Rate	Volume	(Decrease)	Rate	Volume
Interest income						
Loans:						
Commercial	\$ 105	142	\$ (37)	\$ 420	\$ 568	\$ (148)
Real Estate	905	788	117	3,620	3,152	468
Consumer	(91)	(2)	(89)	(364)	(10)	(354)
Total loans	919	928	(9)	3,676	3,710	(34)
Securities:						
Federal agencies	159	93	66	636	374	262
Mortgage-backed	(62)	16	(78)	(248)	62	(310)
State and municipal	(129)	(44)	(85)	(516)	(175)	(341)
Other securities	(50)	2	(52)	(200)	7	(207)
Total securities	(82)	67	(149)	(328)	268	(596)
Deposits in other banks	198	56	142	792	225	567
Total interest income	1,035	1,051	(16)	4,140	4,203	(63)
Interest expense						
Deposits:						
Demand	199	172	27	796	686	110
Money market	66	103	(37)	264	412	(148)
Savings	57	65	(8)	228	262	(34)
Time	465	449	16	1,860	1,795	65
Total deposits	787	789	(2)	3,148	3,155	(7)
Repurchase agreements	156	154	2	624	614	10
Other borrowings	(31)	18	(49)	(124)	73	(197)
Total interest expense	912	961	(49)	3,648	3,842	(194)
Net interest income	\$ 123	90	\$ 33	\$ 492	\$ 361	\$ 131

#### Allowance and Provision for Loan Losses

The purpose of the allowance for loan losses is to provide for losses inherent in the loan portfolio. The allowance is increased by the provision for loan losses and by recoveries of previously charged-off loans. Loan charge-offs decrease the allowance.

The Bank's lenders are responsible for assigning risk ratings to loans using the parameters set forth in the Bank's Credit Policy. The risk ratings are reviewed for accuracy, on a sample basis, by the Bank's Loan Review department, which operates independently of loan production. These risk ratings are used in calculating the level of the allowance for loan losses.

The Bank's Credit Committee has responsibility for determining the level and adequacy of the allowance for loan losses. Among other factors, the Committee on a quarterly basis considers the Bank's historical loss experience; the size and composition of the loan portfolio; individual risk ratings; nonperforming loans; impaired loans; other problem credits; the value and adequacy of collateral and guarantors; and national and local economic conditions. The Audit and Compliance Committee and the Board of Directors review the allowance calculation quarterly.

No single statistic, formula or measurement determines the adequacy of the allowance. Management makes difficult, subjective, and complex judgements about matters that are inherently uncertain, and different amounts would be reported under different conditions or using different assumptions. For analytical purposes, management allocates a portion of the allowance to specific loan categories and specific loans (the allocated allowance). The entire allowance is used to absorb credit losses inherent in the loan portfolio, including identified and unidentified potential losses.

The allowance is supplemented to adjust for imprecision (particularly in commercial, commercial real estate and construction lending) and to provide for a range of possible outcomes inherent in estimates used for the allocated allowance. This reflects the result of management's judgment of risks inherent in the portfolio, economic uncertainties and other subjective factors, including industry trends in the Bank's region.

The relationships and ratios used in calculating the allowance, including the qualitative factors, may change from period to period. Furthermore, we cannot provide assurance that, in any particular period, the Bank will not have sizeable credit losses in relation to the amount reserved. Management may find it necessary to significantly adjust the allowance, considering current factors at the time, including economic conditions, industry trends and ongoing internal and external examination processes.

The Southside Virginia market, in which the Bank has a significant presence, is under economic pressure. The region's economic base has historically been weighted toward the manufacturing sector. Increased global competition has negatively impacted the local textile industry and several manufacturers have closed plants due to competitive pressures or the relocation of some operations to foreign countries. Other important industries include farming, tobacco processing and sales, food processing, furniture manufacturing and sales, specialty glass manufacturing, and packaging tape production. Additional declines in manufacturing production and unemployment could negatively impact the ability of certain borrowers to repay loans.

The unallocated portion of the allowance reflects management's attempt to provide that the overall allowance appropriately reflects a margin for the imprecision necessarily inherent in estimates of credit losses. The allowance is also subject to regulatory examinations and determinations as to adequacy, which may take into account such factors as the methodology used to calculate the allowance and the size of the allowance in comparison to peer banks.

The provision for loan losses was \$126,000 for the three months ended March 31, 2006 versus \$300,000 for the same period in 2005. The annualized ratio of net charge-offs to average loans was .07% in the first quarter of 2006, compared with .15% for the same period in 2005.

The allowance for loan losses was \$6,164,000 at March 31, 2006, an increase of .90% over the \$6,109,000 recorded at December 31, 2005. The allowance represented 1.50% of loans at March 31, 2006 and 1.46% at December 31, 2005. An increase in the unallocated portion of the allowance was principally responsible for the increase in the overall allowance. Management believes the allowance for loan losses is adequate to absorb losses inherent in the Bank's loan portfolio at March 31, 2006. More information regarding loan quality is provided in the "Asset Quality, Credit Risk Management, and Nonperforming Assets" section.

### **Noninterest Income**

Noninterest income for the three months ended March 31, 2006 was \$1,901,000, a decrease of \$166,000 or 8.0% as compared to the same period in 2005; however, excluding prior year special income of \$320,000 from the sale of a debit card and ATM processor, noninterest income increased \$154,000, or 8.8%. Contributing to this increase was growth in trust and investment account fees, service charges, retail brokerage fees, and mortgage banking income, due to increased volume of activity.

Fees from the management of trusts, estates, and asset management accounts totaled \$755,000 in the first quarter of 2006, up from \$720,000 for the same period in 2005, due primarily to new account activity.

Service charges on deposit accounts were \$571,000 during the first quarter, up from \$559,000 for the same period in 2005, due primarily to volume of activity and fee increases.

Other fees and commissions were \$309,000 during the first three months of 2006, up \$58,000 from \$251,000 for the same three month period in 2005. The growth in this category was largely due to increased retail brokerage sales.

Mortgage banking income represents fees from originating, selling and brokering residential mortgage loans. Mortgage banking income was \$133,000 for the first three months of 2006, an increase of 33.0% over the \$100,000 for the first quarter of 2005.

### **Noninterest Expense**

Noninterest expense increased \$392,000, or 9.80%, to \$4,383,000 for the first quarter of 2006, from \$3,991,000 in the first quarter of 2005.

The increase in 2006 included approximately \$203,000 related to the opening of an office in the Lynchburg, Virginia area. The increase in noninterest expense also includes higher pension and employee benefit expense and approximately \$54,000 of costs associated with the acquisition of Community First Financial Corporation.

Salaries and employee benefits were up \$293,000 over the first quarter of 2005 due to additional personnel in the Lynchburg, Virginia office and increases in employee health care insurance. Core deposit intangible amortization declined by \$73,000 as the amortization of the premium paid for deposits acquired at the Gretna office in 1995 had been fully expensed in 2005..

### **Income Tax Provision**

The effective tax rate for the first quarter of 2006 was 29.5% compared to 28.7% for the same period of 2005. The effective tax rate is lower than the statutory rate primarily due to tax-exempt state and municipal securities.

## **FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL**

### **Securities**

Average investment securities decreased \$9,294,000, or 5.1% during the first quarter of 2006, as compared to the same period in 2005.

### **Loans**

Loans, including those held for sale, increased on average from \$410,379,000 in the first quarter of 2005 to \$412,164,000 in the first quarter of 2006, due to growth primarily in real estate loans. Growth in these categories offset declines in commercial and consumer loans.

### **Asset Quality, Credit Risk Management, and Nonperforming Assets**

Management identifies specific credit risks through its periodic analysis of the loan portfolio and monitors general risks arising from economic trends, market values and other external factors. The Bank maintains an allowance for loan losses, which is available to absorb losses inherent in the loan portfolio. The adequacy of the allowance for loan losses is determined on a quarterly basis. Various factors as defined in the section "Allowance and Provision for Loan Losses" are considered in determining the adequacy of the allowance.

The Bank uses certain general practices to manage its credit risk. These practices include (a) appropriate lending limits for loan officers, (b) a loan approval process, (c) careful underwriting of loan requests, including analysis of borrowers, collateral, and market risks, (d) regular monitoring of the portfolio, (e) review of loans by a Loan Review department which operates independently of loan production, (f) regular meetings of a Credit Committee to discuss portfolio and policy changes, and (g) regular meetings of an Asset Quality Committee which reviews the status of individual loans.

Nonperforming loans include loans on which interest is no longer accrued, accruing loans that are contractually past due 90 days or more as to principal and interest payments, and loans classified as troubled debt restructurings. Nonperforming assets include nonperforming loans and foreclosed real estate. Nonperforming loans represented 1.04% of total loans at March 31, 2006, down from 1.93% at March 31, 2005. As discussed in the annual report on Form 10-K, a \$4.5 million hotel loan was sold at a discount, and the balance charged-off, in the fourth quarter of 2005. The reduction in the nonperforming loans since March 2005 was largely due to the resolution of this loan. At December 31, 2005, nonperforming loans were 1.02% of total loans.

The following table summarizes nonperforming assets (in thousands):

	March 31 2006	December 31 2005
90 days past due	\$ -	\$ 56
Nonaccrual	4,274	4,217
Foreclosed real estate	155	188
Nonperforming assets	<u>\$ 4,429</u>	<u>\$ 4,461</u>

### Liquidity

Liquidity is the measure of the Bank's ability to generate sufficient funds to meet customer demands for loans and the withdrawal of deposit balances. Liquidity sources include cash and amounts due from banks, interest-bearing deposits in other banks, loan repayments, increases in deposits, lines of credit from the Federal Home Loan Bank of Atlanta ("FHLB") and two correspondent banks, and maturities and sales of securities. Management believes that these sources provide sufficient and timely liquidity.

Management monitors and plans the Bank's liquidity position for future periods. Liquidity strategies are implemented and monitored by ALCO. The Committee uses a simulation and budget model to manage the future liquidity needs of the Bank.

The Bank's net liquid assets, which includes cash and due from banks and unpledged securities available-for-sale, less the Bank's reserve requirement, to liabilities ratio was 20.4% at March 31, 2006 and 21.3% at March 31, 2005. Both of these ratios reflect adequate liquidity for the respective periods.

The Bank has a line of credit with the FHLB, equal to 30% of the Bank's assets. This amounted to a line of credit in the amount of \$191,470,000 at March 31, 2006. Borrowings under the line were \$17,200,000 at March 31, 2006. Under the terms of its collateral agreement with the FHLB, the Bank provides a blanket lien covering all of its residential first mortgage loans, and home equity lines of credit. In addition, the Bank pledges as collateral its capital stock in and deposits with the FHLB.

The Bank had fixed-rate term borrowing contracts with the FHLB as of March 31, 2006, with the following final maturities (in thousands):

	<u>Amount</u>	<u>Expiration Date</u>
\$	2,000	July 2006
	1,000	July 2007
	3,000	June 2008
	5,000	August 2008
	5,000	April 2009
	1,200	March 2014
\$	<u>17,200</u>	

The Bank also has federal funds lines of credit established with two other banks in the amounts of \$12,000,000 and \$5,000,000, and has access to the Federal Reserve Bank’s discount window. There were no amounts outstanding under these facilities at March 31, 2006.

**Deposits**

Average deposits increased from \$486,618,000 in the first quarter of 2005 to \$497,758,000 in the first quarter of 2006. Growth in demand and time deposits outpaced declines in money market and savings accounts.

**Off-Balance Sheet Transactions**

The Bank enters into certain financial transactions in the ordinary course of performing traditional banking services that result in off-balance sheet transactions. Off-balance sheet transactions were as follows (in thousands):

<u>Off-Balance Sheet Transactions</u>	<u>March 31, 2006</u>	<u>December 31 ,2005</u>
Commitments to extend credit	\$ 130,099	\$ 116,898
Standby letters of credit	2,620	2,625
Commitments to purchase securities	-	-
Mortgage loan rate-lock commitments	2,081	1,716

Commitments to extend credit to customers represent legally binding agreements with fixed expiration dates or other termination clauses. Since many of the commitments are expected to expire without being funded, the total commitment amounts do not necessarily represent future funding requirements. Standby letters of credit are conditional commitments issued by the Bank guaranteeing the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements.

**Capital**

In the first quarter of 2006, the Corporation declared and paid a quarterly cash dividend of \$.21 per share.

On August 16, 2005, the Corporation’s board of directors approved the extension of its stock repurchase plan, begun in 2000, to include the repurchase of up to 200,000 shares of the Corporation’s common stock between August 17, 2005 and August 15, 2006. The stock may be purchased in the open market or in privately negotiated transactions as management determines to be in the best interest of the Corporation. Since December 31, 2005, 13,900 shares were repurchased.

One measure of a financial institution's capital strength is the ratio of shareholder's equity to assets. Shareholders' equity was 11.58% of assets at March 31, 2006 and 11.78% at March 31, 2005. In addition to this measurement, banking regulators have defined minimum regulatory capital ratios for financial institutions. These ratios take into account risk factors identified by those regulatory authorities associated with the assets and off-balance sheet activities of financial institutions. The guidelines require percentages, or "risk weights," be applied to those assets and off-balance-sheet assets in relation to their perceived risk. Under the guidelines, capital strength is measured in two tiers. Tier I capital consists primarily of shareholder's equity, while Tier II capital consists of qualifying allowance for loan losses. "Total" capital is the total of Tier I and Tier II capital. Another indicator of capital adequacy is the leverage ratio, which is computed by dividing Tier I capital by average quarterly assets less intangible assets.

The guidelines require that total capital (Tier I plus Tier II) of 8% be held against total risk-adjusted assets, at least half of which (4%) must be Tier I capital. At March 31, 2006, the Corporation's Tier I and total capital ratios were 16.22% and 17.55%, respectively. At December 31, 2005, these ratios were 16.25% and 17.57%, respectively. The ratios for both periods were in excess of the regulatory requirements. The Corporation's leverage ratios were 11.54% and 11.94% at March 31, 2006 and December 31, 2005, respectively. The leverage ratio has a regulatory minimum of 3%, with most institutions required to maintain a ratio one to two percent above the 3% minimum depending upon risk profiles and other factors.

As mandated by the Federal Deposit Insurance Corporation Act of 1991 ("FDICIA"), the following five capital categories are identified for insured depository institutions: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized". FDICIA requires the federal banking regulators to take prompt corrective action with respect to insured depository institutions that do not meet minimum capital requirements. Under the regulations, well capitalized institutions must have Tier I risk-based capital ratios of at least 6%, total risk-based capital ratios of at least 10%, and leverage ratios of at least 5% and not be subject to capital directive orders. Management believes, as of March 31, 2006, that the Corporation and the Bank met the requirements to be considered "well capitalized."

### **Impact of Inflation and Changing Prices**

The majority of assets and liabilities of a financial institution are monetary in nature and therefore differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. The most significant effect of inflation is on other expenses that tend to rise during periods of inflation. Changes in interest rates have a greater impact on a financial institution's profitability than do the effects of higher costs for goods and services. Through its balance sheet management practices, the Bank has the ability to react to those changes and measure and monitor its interest rate and liquidity risk.



ITEM 3.

### QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

#### Market Risk Management

Effectively managing market risk is essential to achieving the Bank's financial objectives. Market risk reflects the risk of economic loss resulting from adverse changes in interest rates and market prices. The Corporation is not subject to currency exchange risk or commodity price risk.

As a financial institution, interest rate risk and its impact on net interest income is the primary market risk exposure. The magnitude of the change in earnings resulting from interest rate changes is impacted by the time remaining to maturity on fixed-rate obligations, the contractual ability to adjust rates prior to maturity, competition, and the general level of interest rates.

The Asset/Liability Investment Committee ("ALCO") is primarily responsible for establishing asset and liability strategies and for monitoring and controlling liquidity and interest rate risk within established policy guidelines. ALCO is also responsible for evaluating the competitive rate environment and reviewing investment securities transactions.

The Bank uses simulation analysis to measure the sensitivity of projected earnings to changes in interest rates. Simulation takes into account current balance sheet volumes and the scheduled maturities and payments of assets and liabilities. It incorporates numerous assumptions including growth, changes in the mix of assets and liabilities, prepayments, and average rates earned and paid. Based on this information, the model projects net interest income under multiple interest rate scenarios.

Management cannot predict future interest rates or their exact effect on net interest income. Computations of future effects of hypothetical interest rate changes are based on numerous assumptions and should not be relied upon as indicative of actual results. Certain limitations are inherent in such computations. Assets and liabilities may react differently than projected to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while rates on other types of assets and liabilities may lag behind changes in market interest rates. Also, the methodology uses estimates of various rates of withdrawal for money market deposits, savings, and checking accounts, which may vary significantly from actual experience.

The Bank is also subject to prepayment risk, particularly in falling interest rate environments or in environments where the slope of the yield curve is relatively flat or negative. Such changes in the interest rate environment can cause substantial changes in the amount of prepayments of loans and mortgage-backed securities, which may in turn affect the Bank's interest rate sensitivity position. Additionally, credit risk may increase if an interest rate increase adversely affects the ability of borrowers to service their debt.

There have been no material changes to market risk as disclosed in the Corporation's 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 15, 2006. Refer to those disclosures for further information.

ITEM 4.

### DISCLOSURE CONTROLS AND PROCEDURES

The Corporation's management, including the Chief Executive Officer and Chief Financial Officer, evaluated the Corporation's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act") as of March 31, 2006. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Corporation's disclosure controls and procedures are effective. There were no significant changes in the Corporation's internal controls over financial reporting that occurred during the quarter ended March 31, 2006 that have materially affected or are reasonably likely to materially affect the Corporation's internal control over financial reporting.

PART II

OTHER INFORMATION

Item:

1. Legal Proceedings

The nature of the business of the Corporation's banking subsidiary ordinarily results in a certain amount of litigation. The subsidiary of the Corporation is involved in various legal proceedings, all of which are considered incidental to the normal conduct of business. Management believes that the liabilities arising from these proceedings will not have a material adverse effect on the consolidated financial position or consolidated results of operations of the Corporation.

1A. Risk Factors

There have been no material changes to the risk factors as disclosed in the Corporation's 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 15, 2006.

2. Unregistered Sales of Equity Securities and Use of Proceeds

Repurchases made for the Quarter Ended March 31, 2006

2006	Total Number of Shares Purchased	Average Price Paid Per share	Total Number of Shares Purchased as Part of Publicly Announced Program	Maximum Number of Shares that May Yet Be Purchased Under the Program
January 1-31	8,400	\$ 23.24	8,400	165,310
February 1-28	5,500	23.45	5,500	159,810
March 1-31	-	-	-	159,810
	<u>13,900</u>	\$ 23.33	<u>13,900</u>	

On August 16, 2005, the Corporation's board of directors approved the extension of its stock repurchase plan, begun in 2000, to include the repurchase of up to 200,000 shares of the Corporation's common stock between August 17, 2005 and August 15, 2006. The stock may be purchased in the open market or in privately negotiated transactions as management determines to be in the best interest of the Corporation.

3. Defaults Upon Senior Securities

None

4. Submission of Matters to a Vote of Security Holders

None

5. Other Information

(a) Required 8-K disclosures

None

(b) Changes in Nominating Process

None

6. Exhibits

- 11. Refer to EPS calculation in the Notes to Financial Statements
- 31.1 Section 302 Certification of Charles H. Majors, President and CEO
- 31.2 Section 302 Certification of Neal A. Petrovich, Senior Vice President and Chief Financial Officer
- 32.1 Section 906 Certification of Charles H. Majors, President and CEO
- 32.2 Section 906 Certification of Neal A. Petrovich, Senior Vice President and Chief Financial Officer



**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AMERICAN NATIONAL BANKSHARES INC.

/s/ Charles H. Majors

Charles H. Majors

President and Chief Executive Officer

Date - May 10, 2006

/s/ Neal A. Petrovich

Neal A. Petrovich

Senior Vice President and

Chief Financial Officer

Date - May 10, 2006